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No. 79-1515

In the Supreme Court of the United States

OCTOBER TERM, 1980

UNITED STATES OF AMERICA, PETITIONER

v.

ELWOOD SWANK and RITA SWANK

UNITED STATES OF AMERICA, PETITIONER

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA, PETITIONER

v.

BULL RUN MINING CO., INC.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF CLAIMS

REPLY BRIEF FOR THE UNITED STATES

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1. In support of their claims to depletion deductions from their income earned from the sale of coal, respondents each advance markedly different arguments in an attempt to avoid the critical fact that their lessors had the unfettered right to terminate

the leases on 30 days' notice without cause. Thus, Swank asserts (Br. 9-10) that he had an economic interest in the coal in place because his lease effected a sale of the coal under Pennsylvania law. Bull Run, in turn, more broadly contends (Br. 22) that "there is no policy reason why under percentage depletion rules the lessee must have the right to mine the deposit to exhaustion." Finally, Black Hawk dismisses the lessor's right to terminate as "utter[ly] immaterial" (Br. 32).

The decisions of this Court explicitly refute each of these disparate contentions. It has long been established that determination whether a party to a mineral lease has an economic interest in the minerals in place so as to be eligible for the depletion deduction is in no way dependent upon whether the transaction is characterized under state law as a "lease" or a "sale." As the Court observed in *Palmer* v. *Bender*, 287 U.S. 551, 555-556 (1933), "the formal attributes of those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant." See also *id.* at 557; *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364 (1925). Thus, the determination of entitlement to the depletion deduction is a matter of federal law. See *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 32, 33 & n.8 (1946).

Moreover, it is too late in the day to argue that a claimant for the depletion allowance need not have the right to mine a deposit to exhaustion, or that the lessor's right to terminate is immaterial. As we have pointed out in our opening brief (at 16-18), this Court's decision in *Paragon Jewel Coal Co.* v. *Commissioner*, 380 U.S. 624, 634 (1965), established that the right to mine to exhaustion is an essential element

of a depletable economic interest in minerals in place. As the Court there observed, "the contracts did not fix upon the operators an *obligation* to mine to exhaustion" (emphasis in original). Since the operators did not have an obligation to mine to exhaustion, the Court found a corresponding right on the part of the lessor to terminate. This analysis is fully in accord with the Court's earlier decision in *Parsons* v. *Smith*, 359 U.S. 215, 224 (1959), where the Court held that a mining contractor "had no investment or interest in the coal in place," noting in three separate instances that the contracts "were completely terminable without cause on short notice" (*id.* at 224, 225, 226). Indeed, even in *Bakertown Coal Co.* v. *United States*, 485 F.2d 633, 640-641 (1973), to which the decision below adhered (Pet. App. 5a), the Court of Claims acknowledged that this Court in *Parsons* v. *Smith*, *supra*, accorded significant weight to the lessor's right to terminate on short notice without cause.[1] In sum, it cannot be seriously argued that the lessors' right to terminate without cause has no bearing on respondents' entitlement to the depletion allowance.

2. Thus, the question presented is not whether the lessors' right to terminate a lease on short notice without cause is significant—for all the authorities recognize its significance—but whether, as we submit, it

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[1] Contrary to respondents' argument (Swank Br. 17-22; Bull Run Br. 7, Black Hawk Br. 31-35), this Court's decisions in *Parsons* v. *Smith*, *supra*, and *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*, cannot be distinguished on the ground that they involved contract miners rather than lessees such as themselves. The critical inquiry in those cases (and therefore here as well) is whether the taxpayers had an economic interest in the coal in place, regardless of the particular characterization accorded to them in the transaction.

is to be accorded controlling weight. In this respect, respondents alternatively argue (Swank Br. 5, 22; Black Hawk Br. 21-22; Bull Run Br. 8-9) that terminability of a lease is only one of seven factors identified in *Parsons* v. *Smith*, *supra*, and that they should be entitled to the depletion allowance as long as they satisfy the other six factors.

But this contention overlooks the practical economics of a mineral lease. In a rising market where the market price of the coal rises above the lessor's royalty, the lessor would have every incentive to exercise his right to terminate the lease on short notice and either enter into a more profitable lease or mine the coal himself and sell it. Indeed, this hypothesis is hardly fanciful in light of the current emphasis on coal development as an alternative source of energy that is cheaper than oil. Thus, given the lessors' right to terminate these leases on short notice without cause,[2] it blinks reality to conclude, as did the decision below, that respondents had the right to mine even a substantial portion of the deposits. To the contrary, their continued mining activity was completely subject to the will of the lessors. Since the lessors had the

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[2] Respondent Swank argues (Br. 14-15) that his lessor informally recognized that the leases would be terminated only for cause. But the parties stipulated and the trial judge found that "no assurance was given that the [lessor] *could* not cancel a lease without cause" (Stip. ¶ 15(c), J.A. 55a (emphasis in original)). Noting that respondent "failed to except to those findings" (Pet. App. 7a n.8), the court below therefore specifically rejected respondent Swank's claim that his leases could be terminated only for cause. Moreover, the fact that Swank's lessor, Northumberland County, is a governmental unit that does not need the depletion deduction (see Swank Br. 12) is hardly a principled basis upon which to award it to respondent Swank.

right to assume complete dominion over the coal deposits, they—and not respondents—had the requisite economic interest in the mineral in place.

3. Contrary to respondents' further contention (Swank Br. 14, Black Hawk Br. 29-30), the fact that the lessors' termination rights were not exercised during the taxable years at issue does not cast doubt upon the need to accord controlling weight to those termination rights. The question presented is whether respondents, during the taxable years at issue, possessed a depletable economic interest in the coal in place. That question cannot be answered by post hoc rationalizations that the lessors never exercised their termination rights. If such rights are to be given controlling weight because they diminish respondents' right to extract a substantial portion of the coal in place (G. C. M. 26290, 1950-1 Cum. Bull. 42), their non-exercise does not expand or otherwise alter respondents' legal right over the coal during the years at issue. See also Rev. Rul. 77-481, 1977-2 Cum. Bull. 205. Since the depletion allowance turns on the *right* to extract minerals, the possibility of termination is necessarily fatal to respondents' claim to an economic interest in the coal in place. During each of the years in suit, the only right respondents had was to continue mining for an additional 30 days. Such a right is simply insufficient to establish the economic interest in the coal in place necessary to support a depletion deduction.[3]

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[3] Respondent Black Hawk (Br. 38-39) cites the rhetorical question posed by the Court of Claims in the decision below (Pet. App. 8a) and in *Bakertown Coal Co.* v. *United States*, *supra*, 485 F.2d at 642, observing that this Court need not consider whether the lessors' right to terminate on one day's notice deprives the lessee of the depletion deduction. In re-

Indeed, if respondents were correct in arguing that the lessors' termination rights are rendered insignificant because they were not exercised, depletion deductions would inevitably be left in a state of suspense during the term of such leases. In most cases, depletion deductions will be claimed by either the lessor or the lessee, depending upon the terms of their arrangement. Both cannot claim depletion of the same mineral deposit. *Parsons* v. *Smith*, *supra*, 359 U.S. at 220, quoting *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 309 (1956). If the lessor's failure to exercise a right to terminate without cause could affect the nature of the interest possessed by the parties, then conceivably a lessee who initially lacked an economic interest in the mineral in place could acquire such an interest with the passage of time. By the same token, at the time the tenant-at-will acquired his economic interest by virtue of the lessor's failure to exercise a right of termination, the lessor would to that extent lose his right to claim depletion. Conversely, the lessor's exercise of his right to terminate without cause might lend support to his claim to depletion for years prior to the termination. The confusion that would ensue under such a rule would render the mineral tax laws virtually unadministrable, and would leave the parties to such contracts uncertain of their tax consequences at the time they enter into them. Hence, if the economic interest test is to be administered in a practical way, the party claiming a depletable interest in minerals must

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spondent's view (Br. 39), "no individual or corporate lessee would ever agree to any such economically impossible arrangement." But this very question is now pending before the Court of Claims in the context of a turquoise mining agreement. See *Hardy* v. *United States*, No. 412-77.

be required to establish his interest on the basis of enforceable legal rights as determined under the provisions of the lease agreement. Under that test, the lessors,[4] and not respondents, possess the requisite economic interest to support entitlement to the depletion allowance.

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[4] Respondents continue to argue (Swank Br. 25; Black Hawk Br. 8), as the decision below suggested (Pet. App. 9a), that if they are not entitled to the depletion deduction, then no one will be able to claim depletion on the coal mined under these leases. But, as we pointed out in our opening brief (at 22-23), the lessors' eligibility for the special capital gains treatment under Section 631(c) results in the lessors' entitlement to *cost* depletion. If, however, Section 631(c) is inapplicable, the lessor can claim *percentage* depletion, but must report his receipts as ordinary income (see our opening brief —at 23 n.13). As the Tax Court recently stated in *Davis* v. *Commissioner*, 74 T.C. No. 66 (slip op. 18-19) (July 31, 1980):

> Under section 631(c), the "adjusted depletion basis" of the coal is the same amount as would have been the allowance for cost depletion under section 612. Sec. 1.631-3 (b)(2), Income Tax Regs. The allowance for cost depletion under section 612 is the cost or other adjusted basis of the mineral produced as those terms are defined in sections 1011, 1012, and 1016, generally expressed as cost per unit extracted. Secs. 1.611-2(a), 1.612-1, Income Tax Regs. Thus, section 631(c) operates only upon the coal lessor's gross royalty receipts minus the costs of the coal mined, that is, his net royalty income **or loss.**

CONCLUSION

For the reasons stated above and in our opening brief, the judgments of the Court of Claims should be reversed.

Respectfully submitted.

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